

Board of Investment Trustees
Montgomery County Employees' Retirement System

STATEMENT OF INVESTMENT POLICY

The Board of Investment Trustees (the "Board") adopts this policy statement as a guide to its oversight of the investment program of the Employees' Retirement System (ERS) assets. In this regard, the Board recognizes its fiduciary responsibility to manage ERS assets prudently and solely in the interest of plan participants and their beneficiaries and for the exclusive purpose of paying benefits and reasonable administrative expenses.

I. INVESTMENT OBJECTIVES

A. Return Requirements - The ERS investment portfolio will be a discretionary portfolio with a return objective of maximizing return over the long term at prudent and reasonable levels of risk. The return objective of the program emphasizes total return, favoring capital growth over current income. The following ERS plan characteristics justify this objective:

1. Although the ERS system is closed to new participants with the exception of public safety employees, because of the proportion of active to retired lives and because payouts in excess of contributions and normal income remain modest in comparison to the size of the total investment portfolio for the foreseeable future, the ERS portfolio does not need to produce high levels of current income.
2. Being tax-exempt, the ERS portfolio has no tax consequences related to ordinary income versus capital gains.
3. Because benefit obligations are based on average final earnings and are indexed to inflation, benefit obligations are very sensitive to inflation. Thus, real returns are more important than nominal returns in establishing an investment structure to meet return requirements.
4. The goal of the ERS investment program is to achieve a rate of return in excess of the required return established by the Plan Administrator for actuarial purposes. While the Board is cognizant that a total return-based investment program may produce short-term periods of underperformance relative to the actuarial rate, the Board believes that a long-term investment program focused on capital growth can be developed and maintained which is expected to at least achieve, if not exceed, the actuarial rate over the long-term.

B. Risk Tolerance - While focusing on maximizing returns, the ERS investment program pursued by the Board will at all times limit risk to prudent and reasonable levels. The Board recognizes to achieve the Plan's investment objectives requires prudent risk-taking, and that risk is the prerequisite for generating excess investment returns. Therefore the Board's policy regarding investment risk, consistent with modern portfolio theory, is that risk cannot be eliminated but should be managed, and that fiduciaries have the obligation to utilize risk efficiently. This will be accomplished by maintaining a well-diversified ERS portfolio. In addition to diversification by asset class, investments will be diversified by manager styles and market segments, within acceptable ranges. In aggregate, the investments are expected to produce a sufficient return over the long term while prudently managing risk.

Because benefit obligations are long-term and the ERS investment program has limited liquidity or income needs, the portfolio can tolerate above-normal short-term volatility in investment returns. Although the Board recognizes that the ERS investment program has an above-average capacity to bear risk, the Board will set prudent and reasonable risk levels through an evaluation of the risk impact inline with comparable investment portfolios and programs. The Board also recognizes that the performance of certain segments of the ERS portfolio may experience greater volatility than other segments of the portfolio. A full description of the risk management program is detailed in the Board's Risk Management Statement (Exhibit A).

The process by which these return and risk objectives are to be achieved will be established by investment guidelines set by the Board from time to time, and will be well-researched and sensitive to market conditions. In addition to such guidelines, the Board will establish constraints at the policy level, delineated below, to ensure prudent management of the investments. The primary focus of these constraints and guidelines is to ensure compliance with all statutory constraints on the Board's investment program, as well as to establish proper risk controls.

C. Performance Measurement - The performance of the ERS portfolio will be measured in comparison with return calculated on industry-recognized market indices and other relevant indices representing returns achieved by comparable investment portfolios and programs. Although the focus of the ERS investment program is long term, a three- to five year measurement period will be used to evaluate performance of the specific portfolios within the ERS.

II. INVESTMENT PROGRAM STRUCTURE

A. Standard of Care: All investments will be made exercising the Standard of Care as delineated in Section 33-61c of the Montgomery County Code.

A fiduciary must discharge the fiduciary's duties regarding the retirement systems:

- a. *only in the best interest of the participants and their beneficiaries;*
- b. *only to provide benefits to the participants and their beneficiaries, and defray reasonable expenses of administering the retirement systems;*
- c. *with the care, skill, prudence, and diligence under the circumstances that a prudent person acting in a similar capacity and familiar with the same matters would use to conduct a similar enterprise with similar purposes;*
- d. *by diversifying the investments of the retirements systems to minimize the risk of large losses, unless it is clearly not prudent to diversify under the circumstances;*
- e. *according to a good faith interpretation of the law governing the retirement systems;*
- f. *according to a good faith interpretation of the documents and instruments governing the retirement system, if they comply with this Article. (1987 L.M.C., ch. 29, 11; 1998 L.M.C., ch. 27, 1.)*

B. Asset Allocation Policy

1. Policy Targets. The Board will establish asset allocation policy levels from time to time based on analysis of the ERS' liability structure and expected market conditions over a five- to ten-year time horizon. These policy levels will be designated in writing and will include acceptable ranges of exposure for primary asset classes (Exhibit B).

2. Rebalancing Policy. The Board will establish a rebalancing policy that will monitor the asset class levels of the fund (Exhibit C). This policy will be in writing and sets the allowable range of investment for the asset classes of the fund and defines the actions needed when asset class is outside the allowable range. The Board will direct the staff/manager to execute the rebalancing of assets within a reasonable time frame.

C. Authorized Investment Managers - By County statute, all funds in the ERS portfolio must be managed by external investment managers who serve at the pleasure of the Board. These managers have full discretion over acquisitions and dispositions of investments and must adhere to guidelines set forth by the Board from time to time.

D. Authorized Investments - Investments are not restricted by asset class or type and may include any investment deemed prudent by the Board, except as noted in Section E below.

E. Investment Restrictions

1. Legal Prohibitions -

a. Montgomery County Bonds - County statute prohibits investment in Montgomery County and Montgomery County-related bonds.

b. Pooled Real Estate - County statute requires that real estate investment be made only in pooled vehicles in which no more than 10% of the pool is invested in real estate located in Montgomery County.

c. Other Prohibited Transactions - County statute prohibits the Board from engaging in any transaction between the trust and the County or entity controlled by the County in which the Board does not receive appropriate compensation for any investments made or services provided.

2. Derivative Securities - The Board's policy on derivative securities is provided in Exhibit D.

F. International Investing - The Board's specific policy on international investing is provided in an addendum to this statement (Exhibit E).

G. Other Investment-Related Issues

1. Indicia of Ownership - The indicia of ownership of the ERS assets must be maintained within the jurisdiction of the U.S.A. courts, except as permitted by Executive Regulation.

2. Proxy Voting - As proxy voting rights are considered assets of the ERS, the Board recognizes its fiduciary responsibility to ensure that such rights are protected and delegates the authority to the investment managers responsible for such assets. Managers have full discretion to vote such proxies in the interest of the ERS participants and their beneficiaries, and must report voting activity to the Board on at least an annual basis

3. Fees, Commission, and Similar Expenses - The Board acknowledges its obligation to secure all services required to carry out its duties and to pay a fair price for those services. Transactions or trading fees paid from ERS assets must be only the "best execution" as determined in the sole judgment of the advisor ordering the transaction. Full disclosure and Board approval is required to the extent that any portion of fees generated by transactions in an account produce value for an entity other than the ERS.

Adopted: June 4, 1999

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